EDS Isn't Alone in Betting on a Rising Stock

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Dell, Eli Lilly, McDonald's Are Just Some of the Companies Who Take Options on Risky Game

HEARD ON THE STREET

FOR DELL COMPUTER Corp., the potential liability now stands at about $501 million. For Eli Lilly & Co., the potential liability is $150 million. For McDonald's Corp., it's at least $14 million.

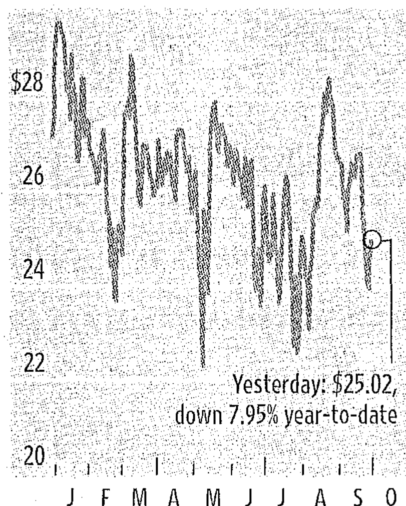
It turns out that Electronic Data Systems Corp. isn't alone in betting—wrongly (for now, anyway)—that its stock would continue to rise. Even as the stock market began its rocky descent two years ago, dozens of other big companies were striking deals with Wall Street investment bankers that, in effect, were bets their stocks would be higher in coming months. Most of these deals were designed to hedge the cost of big share-repurchase programs, and some, like those at EDS, were struck as recently as early this year.

By Robin Sidel, Gary McWilliams and Thomas M. Burton.

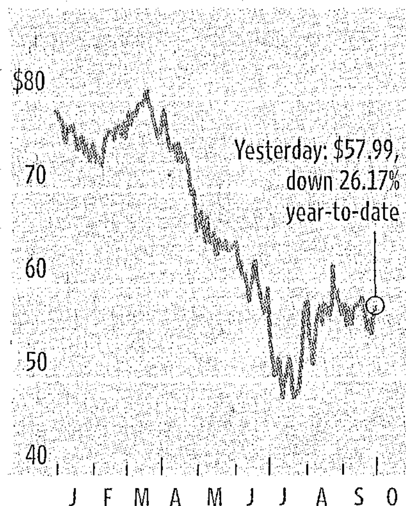
Bets on the Table

Shares of three companies that have sold 'put' options, that is, bet that their stock would rise. Daily share prices.

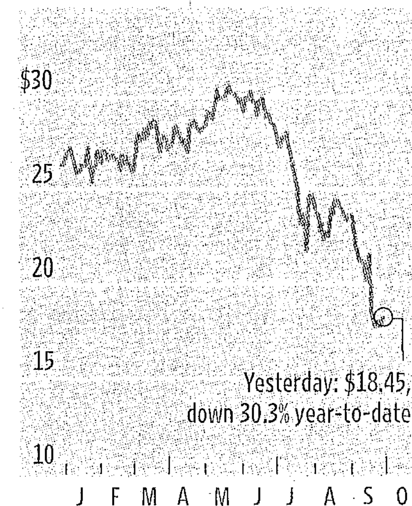
Dell Computer



Eli Lilly



McDonald's



Source: Thomson Datastream

Some big bills already have come due for the bettors. EDS estimates it lost about $100 million in recent months after it was forced to, in effect, buy back 5.44 million shares, including a big gulp last week at prices averaging about $60 apiece while its stock was trading at $17.

On the other hand, for Dell, Eli Lilly and McDonald's, among others, any losses on their currently outstanding transactions are only potential so far. That is because the transactions don't expire for a few weeks to the end of next year, so their stocks still have a chance to rebound and eliminate the current paper losses.

Indeed, some of these companies have been doing these transactions for years and maintain

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Companies 'Put' Up With Risk

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that they have made money at times. "Ours was a deliberate, well-thought-out and a successful strategy. It's just not as successful as it was," says T.R. Reid, a spokesman for Dell, which made many profitable transactions during the bull market but has shelled out big bucks since early 2000, when its stock began dropping along with many other technology shares.

Then there are those companies lucky or smart enough to have quit playing the risky game. Clorox Co., for example, did such deals for years, but it is among the handful of companies that had such agreements in place as late as 2000 and 2001 but have for now given them up.

HEARD ON THE STREET

In general, these deals are of two sorts: One is a "forward purchase agreement," or "equity forward contract," in which a company commits to pay a set price—above the level where the stock is trading as the pact is struck—at some future date. Such deals help a company lock in the price at which it will later buy shares.

The other deal typically involves a "put" option. In connection with share-repurchase programs, companies typically sell such options. In short, the company is providing a buyer the right to sell a specified number of shares to the company at some future date for a specified price. The main benefit to the selling company is the premium income that it earns from the sale—anywhere from pennies to several dollars a share. This money helps a company offset its share-repurchase costs.

The options are called puts because the buyer is obtaining the right to put the contract back to the seller, forcing the deal. In a rising stock market, buyers often let such options expire, because they would get a higher price for any shares they owned by selling on a stock exchange. But in a falling market, these options become more valuable, and the buyers will come calling, as EDS learned.

"Like a lot of people who enter into options contracts, companies might not consider that possibility," says Charlie Conn, a finance professor at Miami University in Oxford, Ohio. "It certainly has the capability to backfire if they can't get out of it."

Since the stock market stalled in early 2000, Dell has spent nearly $2 billion above what open-market purchases would have cost it to repurchase the premium-priced shares required by its "put" warrants, according to a UBS Warburg LLC analysis. It has paid investment banks that bought the puts an average of $44 a share to purchase shares that have traded from $16 to $33 since the start of 2000.

As of Aug. 3, Dell had put obligations covering 22 million shares at an average $47.82 strike price. At 4 p.m. in Nasdaq Stock Market trading yesterday, Dell shares were up 14 cents at $25.02.

"The thinking originally was: 'Can we minimize the expense there?' " says Dell's Mr. Reid. For more than four years, the plan worked like magic: Dell shares kept rising, and the puts expired worthless, allowing the company to benefit from the fees and lower share-repurchase prices. Dell says that, in the six years of its stock buybacks, the derivative contracts have allowed it to buy some 980 million shares back at a below-market average price of less than $15. And the remaining $500 million liability is dwarfed by its $8.6 billion in cash.

Consider Eli Lilly. The drug maker has used equity forward contracts, put options and other financial instruments since 1998. Since 2000, it has posted a $24 million net gain on these pacts, due in part to a stock price that rocketed to more than $100 in 2000.

But Lilly, which has seen its stock tumble to about $55, acknowledges it now faces $150 million in potential exposure from these kinds of contracts. The stock traded in the $70 range in March 2000 when the biggest of the outstanding deals was struck, obligating it to buy 4.5 million shares at $86 to $100 each by the end of 2003. Another requires the company to purchase 900,000 shares at $83; this obligation lasts through November.

Lilly spokesman Rob Smith says the exposure "is not anything that would impact the liquidity of the company at all," noting the company has cash of about $3 billion. The company is optimistic its share price will rise significantly before the end of 2003.

McDonald's, which began using put options in 1992, now has 2.3 million put options outstanding, exercisable at $26.37 to $29.49 a share. McDonald's spokeswoman Anna Rozenich says that, if the options were exercised at today's stock price of about $18, it would cost the company $14 million. That's based on a net price of $24, which is the price that would be paid to exercise the put, less the premium received for selling it. The Oak Brook, Ill., burger company says it sold no new put options this year and is still determining if it will pursue the program next year.

McDonald's shares were up 35 cents to $18.45 at 4 p.m. on the Big Board.

Dow Jones & Co., publisher of The Wall Street Journal, also has entered into put options agreements, with 667,000 shares outstanding as of Dec. 31. Since then, Dow Jones had to buy some of the shares, because the strike price was above the market price. Christopher Vieth, the company's CFO, said the company doesn't publicly disclose the details of such transactions, but that the cost of the transactions to the company was minimal. The last put options expired in April, and Dow Jones doesn't have any more put options contracts outstanding.

—David Bank and Shirley Leung contributed to this article.

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